No. 89-1928

Supreme Court, U.S.
FILED
JUN 8 1990
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SAN ANTONIO SAVINGS ASSOCIATION AND SUBSIDIARIES (RESOLUTION TRUST CORPORATION, RECEIVER)

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-38a) is reported at 887 F.2d 577. The opinion of the Tax Court (App., *infra*, 39a-50a) is reported at 55 T.C.M. (CCH) 813.

JURISDICTION

The judgment of the court of appeals was entered on November 2, 1989. A petition for rehearing was

denied on January 18, 1990 (App., *infra*, 51a-52a). On April 10, 1990, Justice White extended the time within which to file a petition for a writ of certiorari to and including May 18, 1990. On May 4, 1990, Justice White further extended that time to and including June 8, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The relevant portions of Sections 165 and 1001 of the Internal Revenue Code of 1954 (26 U.S.C. (1982)) and Section 1.1001-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set out in a statutory appendix (App., *infra*, 53a-55a).

STATEMENT

1. Respondent is a savings and loan association formerly regulated by the Federal Home Loan Bank Board. In 1980, respondent's mortgage loan portfolio was partially comprised of fixed-rate, long-term home mortgage loans that had been issued in the late 1960s at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. App., *infra*, 3a.

For respondent, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable respondent to realize for tax purposes the loss that resulted from these market changes; it could then utilize the resulting loss deductions to offset current taxable income and produce loss carry-

backs that would generate tax refunds from prior years. There was, however, a catch. Many of these institutions were in such precarious financial condition that a sale of the loans and consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements, raising the prospect of closure by the Bank Board. See App., *infra*, 3a-4a.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of depreciated "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Memorandum R-49 established a list of criteria that would render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.[1] The admitted objective of Memo-

---

[1] Memorandum R-49 specifically provided in part (App., *infra*, 4a-5a):

> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
>
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g., 30 years),
> 4. have identical stated interest rates,

randum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. See App., *infra*, 4a-6a.[2]

2. On September 30, 1980, respondent and two other savings institutions entered into a three-cornered transaction designed to exchange interests in mortgages that satisfied the requirements of Memorandum R-49. Respondent transferred to Farm and Home Savings Association (Farm and Home) a package of 90% participation interests in a group of mortgage loans. Farm and Home transferred to Dallas Federal Savings and Loan Association (Dallas Federal) a package of 90% participation interests in a group of mortgage loans. Dallas Federal trans-

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5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

[2] A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." See App., *infra*, 5a.

ferred to respondent a package of 90% participation interests in a group of mortgage loans.[3] Thus, respondent in effect exchanged interests in a group of residential mortgage loans for interests in a group of residential mortgage loans held by Dallas Federal. The participation interests exchanged were in loan packages having almost identical face and market value, and the loans involved were "substantially identical" under the criteria of the Bank Board's Memorandum R-49. App., *infra*, 6a-7a, 41a-42a.

The transaction was arranged as "reciprocal sales" of the mortgage interests among the parties; it was consummated by conveyance of the participation interests together with simultaneous (and largely offsetting) wire transfers of cash. Respondent conveyed participation interests having a face value of $74,774,495 to Farm & Home in exchange for $59,817,597 in cash. At the same time, respondent obtained from Dallas Federal participation interests having a face value of $74,802,167 in exchange for $60,925,730 in cash. In effect, respondent exchanged loans with a face amount (and cost basis) of $74,774,495, but a lower value, for participation interests held by Dallas Federal with a value of $60,925,730. On its federal income tax return for the year ending September 30, 1980, respondent claimed a deduction for a loss on the transaction of $14,956,898, which corresponded to the reduction in value of the mortgage interests originally held by respondent. App., *infra*, 6a-7a, 41a-42a. Pursuant to Memorandum R-49,

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[3] Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgages could maintain its relationship with the obligor on the loans. See *Cottage Savings Ass'n* v. *Commissioner*, 90 T.C. 372, 381 (1988), rev'd, 890 F.2d 848 (6th Cir. 1989).

however, respondent did not report any loss for financial and regulatory accounting purposes. Doc. 18, at 2.

3. On audit, the Commissioner determined that respondent was not entitled to its claimed deduction for a loss on the mortgage exchange transaction. Respondent sought redetermination of the resulting income tax deficiencies in the Tax Court. While respondent's motion for summary judgment was pending, the Tax Court decided *Cottage Savings Ass'n* v. *Commissioner*, 90 T.C. 372 (1988), rev'd, 890 F.2d 848 (6th Cir. 1989), in which the Tax Court allowed a loss deduction on a mortgage swap transaction similar to the transaction in issue here. In ruling on respondent's motion for summary judgment in the instant case, the Tax Court stated that, when the facts here were construed most favorably for the Commissioner, they were essentially the same as those found by the court in *Cottage*. App., *infra*, 40a-41a. Accordingly, in deciding the case, the Tax Court assumed that respondent, like the taxpayer in *Cottage*, "did not investigate individual loan files, employment histories of the individual borrowers, or the underlying value of the real estate securing the individual loans" (90 T.C. at 382), and that the transaction was "motivated solely by the desire of [respondent] and its trading partners to recognize for tax purposes (but not for regulatory purposes) the losses in market values of the loan portfolios" (90 T.C. at 384). See also App., *infra*, 45a; *Cottage*, 90 T.C. at 388 n.9.

The Commissioner's primary argument was that a loss is "realized" for tax purposes on an exchange of property only if the exchanged properties are "materially different" and that mortgages that were "substantially identical" under the Memorandum R-49 criteria were not materially different. Relying

on its decision in *Cottage*, the Tax Court concluded that the loans transferred by respondent were "materially different" from the loans it received because the loans had different borrowers and different collateral. App., *infra*, 45a-49a. The court also rejected the government's argument that, because the mortgage exchange lacked economic substance, deduction of the loss was not authorized by Section 165 of the Internal Revenue Code (*id.* at 44a).

4. The court of appeals affirmed (App., *infra*, 1a-38a). The court agreed with the government's position that a loss is realized on an exchange only if the properties exchanged are "materially different" (887 F.2d at 581-587). The court then agreed with the Tax Court, however, that the mortgages exchanged in an R-49 transaction are "materially different" because the mortgages have different borrowers and different collateral, even though the Bank Board had identified the mortgages as "substantially identical" (*id.* at 587-592) . The court also rejected the government's additional argument that the exchange lacked economic substance, and therefore no loss could be deducted under Section 165 of the Code (*id.* at 592-593).

REASONS FOR GRANTING THE PETITION

This case was heard by the court of appeals together with two other cases involving mortgage exchanges that satisfied the criteria of Memorandum R-49, and all three cases were decided by the same panel on the same day. See *Centennial Savings Bank* v. *United States*, 887 F.2d 595 (5th Cir. 1989) ; *First Federal Savings & Loan Ass'n* v. *United States*, 887 F.2d 593 (5th Cir. 1989). We are today also filing certiorari petitions in those two cases, presenting the same question regarding the tax treatment of mort-

gage exchanges under Memorandum R-49 that is presented in this case. As we explain in detail in our petition in *Centennial*, review of this question by this Court is warranted because there exists a square conflict in the circuits and the issue is of considerable importance to the administration of the federal tax laws.[4]

Although the Fifth Circuit treated this case as the lead case, we do not urge the Court to grant plenary review here. In July 1989, the Bank Board found that respondent was insolvent and appointed the Federal Savings and Loan Insurance Corporation (FSLIC) as receiver. The Resolution Trust Corporation (RTC) later became the receiver. The RTC has advised us that, in its view, respondent does not have (and never will have) sufficient assets to allow collection of any part of the tax deficiency at issue here in the event the Commissioner ultimately were to prevail in the instant case.[5] The Fifth Circuit, in a case involving a claim by a private creditor against a savings institution that was under FSLIC receivership, recently took the position that a case could be dismissed as moot if there will never be any assets from which to satisfy a judgment. *Triland Holdings & Co.* v. *Sunbelt Service Corp.*, 884 F.2d 205, 208 (5th Cir. 1989). In light of the uncertainty regarding collection here and the question of possible mootness, we believe that the *Centennial* case, which also presents a second issue warranting the attention of this Court, and the *First Federal* case are more suitable vehicles for resolving the conflict in the circuits on the issue

[4] We are supplying respondent's counsel with a copy of our petition in *Centennial*.

[5] The question of collectibility is not addressed in the record in this case.

that is presented in all three cases. Accordingly, we believe it would be appropriate for the Court to hold this petition pending the outcome of *Centennial* and *First Federal.*

CONCLUSION

The petition for a writ of certiorari should be disposed of as appropriate in light of this Court's disposition of *United States* v. *Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89——, and *United States* v. *First Federal Savings & Loan Ass'n*, No. 89——.

Respectfully submitted.

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JUNE 1990

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* The Solicitor General is disqualified in this case.

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 88-4717

SAN ANTONIO SAVINGS ASSOCIATION
AND SUBSIDIARIES, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLANT

APPEAL FROM THE DECISION OF TAX COURT
OF THE UNITED STATES

Nov. 2, 1989

Before BROWN, WILLIAMS and JOLLY, Circuit Judges.

JERRY S. WILLIAMS, Circuit Judge:

The Commissioner of Internal Revenue appeals the tax court's grant of summary judgment to San Antonio Savings Association on its petition for redetermination of a deficiency. The tax court held that San Antonio Savings had realized a recognizable loss by

exchanging 90% participation interests in first-mortgage loans in a triangular transaction with two other entities. The court held: (1) The transaction involved the exchange of participation interests in materially different first-mortgage loans. Because the mortgages were materially different, the exchange constituted a "realization event" for purposes of 26 U.S.C. § 1001. (2) The transaction did not "lack economic substance" and hence did not fall under the non-recogniiton provisions of 26 U.S.C. § 165 and Treas. Reg. § 1.165-1(b). The loss was therefore recognized under the Code. We affirm.

FACTS AND PRIOR PROCEEDINGS

This case presents the first review by this Court of the tax treatment to be given to "reciprocal mortgage sales" conducted pursuant to the Federal Home Loan Bank Board's Memorandum R-49.[1] In dispute is a

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[1] Our research reveals only five cases (aside from the one at issue) which rule on tax treatment Memorandum R-49 transactions, none of them by appellate authority:

(1) *First Federal Sav. & Loan Ass'n of Temple v. United States*, 694 F.Supp. 230 (W.D.Tex. 1988).

(2) *Centennial Sav. Bank F.S.B. v. United States*, 682 F.Supp. 1389 (N.D.Tex.1988).

(3) *Leader Federal Sav. and Loan Ass'n of Memphis v. Commissioner*, 57 T.C.M. (CCH) 846 (1989).

(4) *Federal National Mortgage Ass'n v. Commissioner*, 90 T.C. 405 (1988).

(5) *Cottage Savings Ass'n v. Commissioner*, 90 T.C. 372 (1988).

The two district court cases of *Temple* and *Centennial* are currently before this Court and are decided this day pursuant to a consolidated appeal with the instant case. Two of the tax court cases, *Federal National Mortgage Ass'n* and *Cottage*

deduction of $14,956,898 in losses which San Antonio Savings Association ("SASA") claims as a result of a "reciprocal sale" pursuant to Memorandum R49. The sale consisted of a group of 90% participation interests in residential first-mortgage loans.

SASA is a Texas corporation operating as a savings and loan association. Since the late 1970s there has been a financial crunch in the savings and loan ("S & L") industry. This downturn was due (at least in part) to the fact that many S & Ls' mortgage loan portfolios contained numerous fixed-rate, long-term mortgage loans on residential property which had been issued at interest rates significantly lower than those charged on more recent loans. High market interest rates were experienced in the late 1970s and early 1980s which made many S & Ls' older, low interest loans worth less at the fair market value. SASA was among the many institutions experiencing this difficulty.

The regulatory body of the S & L industry, the Federal Home Loan Bank Board (FHLBB), 12 U.S.C. § 1437 (1982), requires its member institutions to maintain certain liquidity levels for regulatory and financial accounting purposes. While many of the S & Ls wished to sell their low-interest mortgage loans, recognize their accumulated losses, and receive tax refunds for the losses, they could not do so without reporting the losses for the FHLBB's regulatory purposes. The reported losses in many in-

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Savings are currently on appeal before the Sixth Circuit. While this opinion rules only on SASA's appeal, we refer throughout to the *Centennial* and *Temple* opinions because of frequent reference to these cases by both parties and because they represent differing positions on the issues involved in this case.

stances would have brought the S & L's liquidity, at least temporarily, below the minimum required by the FHLBB.

Memorandum R-49 was devised by the FHLBB as a solution to this problem. Memorandum R-49 reads:

> SYNOPSIS: A LOSS NEED NOT BE RECORDED FROM "RECIPROCAL SALES" OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS.
>
> The purpose of this memorandum is to advise OES staff [the FHLBB's Office of Examination and Supervision] on the proper accounting for reciprocal sales of mortgage loans.
>
> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
>
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g., 30 years),
> 4. have identical stated interest rates,
> 5. have similar seasoning (i.e., remaining terms to maturity),
> 6. have aggregate principal amounts within the lesser of 2½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,

7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

* * * *

If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.

Memorandum R-49, issued by the Director of the FHLBB Office of Examination and Supervision (OES) to OES staff, June 27, 1980.

Thus, the admitted objective to Memorandum R-49 was to allow S & Ls to engage in transactions which would allow them to realize their losses on mortgage loans for federal income tax purposes, but which would not be treated as giving rise to losses for regulatory accounting purposes. A memorandum from the Director of the OES to an Executive Staff Director of the FHLBB explained the purpose of the ten criteria set forth in Memorandum R-49.

> Our objective . . . was to structure a transaction which was as close as possible to the IRS "materially different" definition which would still not change the economic position of the association after it engaged in the swap. It was and remains
> * * * our opinion that Memorandum R-49 represents a transaction which is on a fine line between "substantially identical" and "materially different."
>
> These criteria represented our attempt to maintain the association's position with respect to

three types of risks in a loan portfolio. These risks relate to credit (collectibility), rate (future earnings potential), and repayment (extent of principal repayments and prepayments). In our opinion, a change in any of these risks would change the economic factors underlying an association's loan portfolio and, as a result, require recording the resulting gain or loss.

On September 30, 1980, SASA and two other savings instiutions, Farm and Home Savings Association ("Farm and Home") and Dallas Federal Savings and Loan Association ("Dallas Federal"), engaged in a three-cornered transaction designed to satisfy the requirements of Memorandum R-49. The agreements on each side of the triangular transaction were consummated by reciprocal conveyances of participation interests in first mortgage loans and simultaneous wire transfers of cash. SASA transferred to Farm and Home 90% participation interests in each of approximately 1,808 conventional first-mortgage loans owned by SASA. On the same date, SASA received a wire transfer of cash from Farm and Home to equalize the value. All of the transferred participation interests were in mortgage loans secured by residential properties located within the metropolitan area of San Antonio.

In the second leg of the transaction SASA acquired 90% participation interests in each of approximately 1,834 conventional first-mortgage loans owned by Dallas Federal. SASA transmitted cash to Dallas Federal to equalize the value. Residential properties located within the Dallas metropolitan area secured all the mortgage participation interests. On November 15, 1980, the number of participation interests acquired by SASA from Dallas Federal was slightly

reduced so SASA's net payment for the participation interests was also reduced.

On the same date Farm and Home transferred to Dallas Federal 90% participation interests in another set of conventional mortgages completing the triangular transaction. The cash payment from Dallas Federal to Farm and Home and the remaining principal balances on those mortgages were roughly the same as the principal balances and cash amounts involved in the two other participation interest transfers.

The difference between the face value of the participation interests in the mortgages given by SASA to Farm and Home and the amount received for them was $14,956,898. This amount then formed the basis for SASA's claimed deduction. The IRS however did not credit this deduction and sent SASA a notice of deficiency. SASA then appealed to the tax court for a redetermination of deficiency and later moved for summary judgment on the issue.

$14,956,898 appears to be the actual reduction in value experienced by SASA on the 90% participation interests. In other words, if SASA had sold these participation interests in the secondary market for mortgages, $14,956,898 is the amount of loss it would have realized. The IRS does not claim that SASA did not experience a genuine depreciation on these participation interests in the amount of the claimed deduction. The IRS instead argues that SASA did not "realize" its loss through the R-49 transaction, because SASA merely swapped mortgages that were not materially different, leaving itself in the same economic position as prior to the transaction. Alternatively, the IRS argues that 26 U.S.C. § 165 precludes "recognition" of the losses claimed because the transaction "lacked economic substance." The tax

court rejected both these arguments, granted summary judgment for SASA, and entered a decision that no deficiencies were due. *San Antonio Savings Association v. Commissioner*, 55 T.C.M. (CCH) 813 (1988).

This Court has jurisdiction to review the decisions of the tax court "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." 26 U.S.C. § 7482 (1982). We therefore examine this decision as we do other summary judgment decisions. Because the dispute concerns findings of law, we review on a *de novo* standard.

I. *The Material Difference Requirement*

The IRS contends that before gain or loss can be realized on the exchange of property, the items involved must be "materially different". Hence the IRS argues that no loss was realized by SASA in the R-49 transaction because the mortgages exchanged were not "materially different." The IRS depends heavily in this argument on Treasury Regulation § 1.1001-1(a), associated with 26 U.S.C. § 1001, which states:

> *Computation of gain or loss*
>
> (a) *General Rule.* Except as otherwise provided in subtitle. A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Treas.Reg. § 1.1001-1(a). SASA takes the position that there is no requirement that the items being exchanged be materially different before such an exchange results in realization.

Before examining the merits of this argument, a conclusion must be drawn that the transaction is an "exchange". While the tax court below never explicitly ruled on whether the transaction was an exchange or a sale, it continually characterized the transaction as an exchange throughout its memorandum opinion. Furthermore, the court held that for summary judgment purposes, when the facts of the case were construed most favorably for the IRS, they were essentially the same as those found in *Cottage Savings Association v. Commissioner*, 90 T.C. 372 (1988). *SASA*, 55 T.C.M. at 814. In *Cottage Savings*, a case involving a similar R-49 transaction with four parties, the tax court held that the four-cornered transaction could not be regarded as a set of separate sales between the contracting parties. Each purchase and sale was interdependent, each party essentially using the money from its sale to finance its purchase. The court therefore held that while the sale agreements did not expressly make the purchases interdependent, the transaction viewed as a whole was a four-cornered exchange or swap. "Thus, we have adopted, for purposes of our opinion, respondent's characterization of the transactions as exchanges." *Cottage Savings*, 90 T.C. at 387. We conclude that the transaction properly is viewed for purposes of this appeal as a three-cornered exchange.

A. Realization

The key issue under Treas.Reg. § 1.1001-1(a) is the well established concept of "realization" of income. We turn to this critical issue.

"[R]ealization is so basic to the taxing structure of existing law that the general principal is simply not challenged." 1 Bittker, *Federal Taxation of In-*

come, Estates and Gifts, ¶ 5.2(1981). The principle however is one which "emerges from the Internal Revenue Code largely by indirection." *Id.* ¶ 40.1

The realization requirement takes shape when § 61(a)(3) is combined with § 1001(a).[2] Section 61 (a) of the Internal Revenue Code ("the Code" or IRC) states that 'gross income means all income from whatever source derived, including (but not limited to) . . . (3) Gains derived from dealings in property." 26 U.S.C. § 61(a) (1982). The Code does not define the term "dealing" and it does not expressly state that gains and losses are disregarded until an act constituting "dealing" in property takes place. Section 1001(a) provides that:

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1001 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

26 U.S.C. § 1001(a) (1982).

SASA argues that realization occurs for tax purposes if: (1) a genuine gain or loss occurs, and (2) that gain or loss is "fixed" by a disposition of the property in question through which the owner completely terminates his rights to the property producing the gain or loss. SASA therefore contends that a realization event occurred when each party completely terminated its ownership rights to the property exchanged even though it received back other

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[2] Unless otherwise indicated, all section (§) references are to the Internal Revenue Code, 26 U.S.C. § 1 *et. seq* as amended and in effect during the years at issue.

property similar in type to the property transferred. The IRS insists upon a different concept of realization, arguing that termination of rights to a property is not a realization event if the party immediately replaces the property in question with similar property. In the context of an exchange, this contention requires the property exchanged to be "materially different."

SASA's position is reflected in one of the other two district court decisions before us pursuant to this consolidated appeal. *First Federal Sav. and Loan Ass'n of Temple v. United States*, 694 F.Supp. 230 (W.D.Tex. 1988) (*"Temple"*). The government's position is adopted in the second district court opinion before us on consolidated appeal, *Centennial Sav. Bank FSB v. United States*, 682 F.Supp. 1389, 1397-98 (N.D. Tex.1988), as well as two tax court cases, *Federal Nat'l Mortgage Ass'n v. Commissioner*, 90 T.C. 405, 421-22 (1988) (hereafter *"FNMA"*) and *Cottage Savings*, 90 T.C. at 390-94. (1988). Each of these four lower court decisions examines the issue involved in this case, the deductibility of losses on mortgages pursuant to an R-49 transaction between two S & Ls. We therefore examine each of these cases in turn. Our conclusion is that the applicable authority establishes that in order for an exchange to constitute a realization event the items being exchanged must be "materially different" under the tax code.

1) *Realization as formal disposition—the Temple interpretation of realization*

SASA's interpretation or the requirements of realization is the same as the one used in *Temple*. It states that there are only two components to realization.

> First, there is the economic (or what can be called the "common sense") aspect of realization. That is, "Has there been an actual economic gain or loss?" This is generally put in terms of an economic increase or decrease in a taxpayer's net worth. This aspect has often been summed up by the famous paraphrase from *Eisner v. Macomber*, "Is the taxpayer, in fact, riched or poorer?" Second, there is the practical accounting aspect of realization. Namely, that for accounting and valuation purposes the increase or decrease in a taxpayer's net worth (*i.e.* the value of his assets) will not be accounted for ("realized" as a practical matter) until there is some "event that freezes or fixes the gain with sufficient certainty so that it is proper to tax it." *Bittker, supra* at ¶ 5.1 (quoting Lowndes, Current Conception of Taxable Income, 25 Ohio St. L.J. 151, 173, (1964)); *see also Helvering v. Horst*, 311 U.S. 112, 115, 61 S.Ct. 144, 146, 85 L.Ed. 75 (1940) (Holding that as a rule of administrative convenience, "realization" for tax purposes must be connected to a taxable event).

Temple, 694 F.Supp. at 239. *Temple* concludes that the items swapped in an exchange do not have to differ materially from each other before a realization event occurs. *Id.* at 239-42. *Temple* did not offer any specific authority, however, for its conclusion that realization is only a two-step process, not requiring the examination of the items being exchanged. Bittker and *Horst* both state that a realization event is required, but neither states that the realization event requires *only* termination of legal rights to the property earning the gain or loss. 1 Bittker, *supra*, at ¶ 5.1; *Horst*, 311 U.S. at 115, 61 S.Ct. at 146.

Temple holds that the government's position is really better characterized as one claiming that the R-49 transaction should not be *recognized.* In *Temple's* view realization is only concerned with fixing gain or loss at a given time, whereas the nonrecognition sections of the Code are concerned with analyzing the substance of a transaction. *Temple,* 694 F.Supp. at 242. A practical problem with this position is that it places no limits on realization through meaningless exchanges. Realization of gain or loss would occur if farmer A exchanged 1,000 bushels of Kansas spring wheat with farmer B for 1,000 bushels of Kansas spring wheat or if individual C exchanged his 1969 red Ferrari with individual D's 1969 red Ferrari (of the same model), both of which had been garaged and never driven. As SASA acknowledges, this doctrine would lead to deduction of the losses sustained on these transactions absent a specific Code non-recognition provision.

Furthermore, the case authority establishing the realization requirement and later applying it to exchanges does not hold that formal termination of a property right alone is sufficient to establish a realization event. The early corporate reorganization/stock swap cases, the bond/debt modification cases, and the substance-over-form cases all support the material difference requirement. The other R-49 cases which held that material difference was required in an exchange for realization to occur each relied on one of these different lines of authority. Hence we examine each R-49 case and its underlying authority separately.

2) *Centennial and the material difference requirement*

Centennial analyzed an R-49 transaction similar to the one at issue and concluded that a material difference between items exchanged is required before realization can occur. *Centennial* based this view on three older Supreme Court cases beginning with the premier case on realization in exchanges *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920). *See also Marr v. United States*, 268 U.S. 536, 45 S.Ct. 575, 69 L.Ed. 1079 (1925); *Weiss v. Stearn*, 265 U.S. 242, 44 S.Ct. 490, 68 L.Ed. 1001 (1924). From these early realization cases emerges the principle that the receipt of something materially different ("a thing really different") from that which the taxpayer had previously is necessary for an exchange to be considered a realization event.

The parties in the cases before us rely heavily on *Eisner v. Macomber* and the other early cases. *Eisner v. Macomber*, created the well established principle that the typical stock split does not create income tax liability. Recharacterization of these rights did not trigger realization.[3]

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[3] The *Centennial* court focused on language in *Eisner v. Macomber* stating that because the stockholder holds the same percentage of the corporation after the issuance of stock dividends as she did prior to the issuance, "the corporation is no poorer and the stockholder is no richer than they were before." 252 U.S. at 203, 40 S.Ct. at 191-92. *Centennial* then concluded that *Eisner v. Macomber* endorsed an analysis of the change in the taxpayer's economic status resulting from the transaction to determine whether a realization event had occurred. *See* Section II, *infra*. Later on in the *Eisner v. Macomber* opinion, however, the Supreme Court stated that the stock dividend indicated "that the shareholder is the richer because of an increase in [her] capital, [but] at the same time

The case of *Weiss v. Stearn* further elaborates what constitutes a realization event. In *Weiss*, the assets of the original corporation were transferred to a newly formed corporation within the same state. Money was transferred from new investors back to the old shareholders and at the conclusion of the transaction the old shareholders and the new investors each had 50% of the stock in the new corporation. The result of the transaction was the same as if the old shareholders had sold half their shares, and they paid tax on that half but not on the entire transaction. The Supreme Court stated:

> We cannot conclude that mere change for purposes of reorganization in the technical ownership of an enterprise, under circumstances like those here disclosed, followed by issuance of new certificates constitutes gain separated from the original capital interest. *Something more is necessary—something which gives the stockholder a thing really different from what he therefore had.*

Weiss, 265 U.S. at 254, 44 S.Ct. at 491-92 (emphasis added). Under *Weiss*, a formal change in ownership is not enough to trigger realization. In order for realization to occur, the party to an exchange must receive something really different than he previously had and the old stockholders did as to one-half of their investment.

Finally the third of the seminal cases considered by the parties, *Marr*, showed that the requirement of "something really different" depends on the circum-

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shows [she] has not realized or received any income in the transaction." *Eisner v. Macomber*, 252 U.S. at 212, 40 S.Ct. at 195.

stances, and does not require extensive economic analysis. In *Marr* a corporate reorganization took place in which stockholders of the General Motors Corporation of New Jersey were allowed to trade their stock for new stock in the General Motors Corporation of Delaware. The assets of the New Jersey corporation were all transferred to the Delaware corporation, and the New Jersey corporation was dissolved. Marr received 451 shares of preferred stock and 2,125 shares of the common stock in the Delaware corporation, worth considerably more than the purchase price of the 339 shares of preferred and 425 shares of common stock in the New Jersey corporation which he exchanged. Marr claimed that the principles of *Weiss* applied to his case, and that he should not have been held to have experienced a realization event in this stock swap. The Supreme Court, however, held that the two corporations were essentially different because they were controlled by different laws and also that the shares differed in their nature. Realization was found to have occurred.

SASA and the other S & Ls in this consolidated appeal maintain that the *Centennial* court misinterpreted these three early Supreme Court taxation cases, and argue that three other cases from the *Eisner v. Macomber* era show that formal disposition of property is all that is required for a realization event to occur. Those three cases are *Cullinan v. Walker*, 262 U.S. 134, 43 S.Ct. 495, 67 L.Ed. 906 (1923), *Rockefeller v. United States*, 257 U.S. 176, 42 S.Ct. 68, 66 L.Ed. 186 (1921), and *United States v. Phellis*, 257 U.S. 156, 42 S.Ct. 63, 66 L.Ed. 180 (1921).

The facts of *Phellis* parallel those of the transaction in *Marr*. A stockholder in a New Jersey corporation received a stock dividend of two shares in a Dela-

ware corporation for every one share he held in the New Jersey corporation. The assets of the New Jersey corporation were transferred to the Delaware corporation. The New Jersey corporation continued as a going concern but, except for the "redemption of its outstanding bonds, the exchange of debenture stock for its preferred stock, and a holding of debenture stock to an amount equivalent to its own outstanding common and the collection and disposition of dividends thereon, it has done no business." *Phellis*, 257 U.S. at 167, 42 S.Ct. at 65.

The Supreme Court held that the transfer of assets to the new company and of stock from it to the stockholders of the old company "changed the former situation materially." *Id.* at 170, 42 S.Ct. at 66.

> [W]e cannot regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests *materially different* from those incident to ownership of stock in the old company.

Id. at 173, 42 S.Ct. at 67. Distribution of the assets of the new company to the shareholders of the old company therefore constituted a realization event. *Phellis* clearly implies that if the exchange of stock resulted in ownership in entities which were "substantially identical" then a realization event would not occur.

In the *Rockefeller* and *Cullinan* cas. the Court held that the facts were essentially indistinguishable from those presented in *Phellis*. Both *Rockefeller* and *Cullinan* involved corporate reorganizations in which a corporation was split into two or three new entities, but in which the original stockholder received a per-

centage of the stock of the new entities identical to his percentage of ownership in the old corporation.

Phellis, *Rockefeller*, and *Cullinan* do not establish that an exchange of items which differ from each other only formally nevertheless constitutes a realization event.

3) *FNMA and the debt modification cases*

The tax court in *FNMA* held that

> [i]n determining whether property received by a taxpayer in an exchange differs materially from the property exchanged so that the exchange results in realized losses and gains, courts compare the two properties to determine whether the taxpayer has acquired "a thing really different from what he theretofore had."

FNMA, 90 T.C. at 422. In stating this rule the tax court in *FNMA* relied on two cases involving the exchange of original municipal bonds for refunding bonds. *Girard Trust Co. v. United States*, 166 F.2d 773, 774 (3rd Cir. 1948); *Emery v. Commissioner*, 166 F.2d 27 (2nd Cir. 1948). In each of these cases the courts concluded that the refunding bonds differed materially from the bonds for which they were exchanged and thus a recognizable (and hence realized gain) had occurred.[4]

In several other bond/debt modification cases, the courts have held that the refunding bonds *were not* different in kind from the original bond, and hence no realization event occurred. *Mutual Loan and Sav-*

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[4] Although *Emery* applied a predecessor of Treas.Reg. § 1.1001-1(a) in determining whether material difference between the bonds existed, it relied on both the statute and the regulation as establishing the requirement of a material difference. *Emery*, 166 F.2d at 29.

ings Co. v. Commissioner, 184 F.2d 161, 165 (5th Cir. 1950); *C.M. Hall Lamp Co. v. United States*, 97 F. Supp. 481, 486-87 (E.D. Mich. 1951); *West Missouri Power Co. v. Commissioner*, 18 T.C. 105, 111 (1952).

SASA argues that these debt modification cases are not good authority for the material difference requirement, because these cases involved "constructive exchanges" rather than genuine exchanges. Several of these cases however did involve actual exchanges of the old bonds for the new bonds. *See Mutual Savings*, 184 F.2d at 162; *Emery v. Commissioner*, 166 F.2d at 28; *West Missouri Power Company*, 18 T.C. at 109-111. Furthermore, SASA never offers an explanation for why a "constructive exchange" should be treated differently from an "actual exchange," other than asserting that because the borrower, debtor, and underlying property were all normally the same in these cases, other factors had to be considered.

Finally, it is argued that both these cases and the earlier corporate reorganization cases deal with "A for A" transactions in which a stock or bondholder trades in his asset for a new type of stock or bond. Hence, it is argued that realization occurs if a taxpayer (1) sells or disposes of his property or (2) exchanges his property for a different interest in the *same property*. In other words, the material difference requirement only applies if the taxpayer is exchanging his property for a different interest in the same property. This distinction is not the law. In *Marr* the court relied not only on the difference in the interest received but also on the difference in the corporations. In *Phellis*, the fact that corporations were not substantially identical was sufficient to create a material difference. Hence the material differ-

ence requirement applies to "A for B" transactions as well.

B. Treasury Regulation § 1.1001-1(a) and the requirement of material difference

Contrary to SASA's contention and the *Temple* opinion, Treasury Regulation § 1.1001-1(a), quoted earlier, supports the government's argument that before an exchange constitutes a realization event a material difference is required between the exchanged items. Thus, the government asserts that a material difference requirement found in the caselaw is also found in the regulations themselves.

It is true that Treas. Reg. § 1.1001-1(a) does not in its terms create the requirement of material difference. The concept of realization is what creates the material difference requirement. Treas. Reg. § 1.1001-1(a) states that "gain or loss *realized* . . . from the exchange of property differing materially either in kind or extent is treated as income or loss sustained" (emphasis added). The semantic difficulties urged by SASA and the court in *Temple* are linked to the omission of a specific statement in Treas. Reg. § 1.1001-1(a) conditioning realization upon a material difference between the items exchanged. Because the material difference requirement is already inherent in the concept of realization, however, the "differing materially" language in Treas. Reg. § 1.1001-1(a) may be read as a *reference* to an established requirement rather than as establishing the requirement.

SASA and the *Temple* opinion also argue that there could be no "material difference" requirement for realization because it would rob the Code's nonrecognition sections of their purpose. Treasury Regulation § 1.1002-1 states the general rule that gain or

loss which is "realized" must be "recognized" under the Code, unless a nonrecognition provision applies. The general principle of narrow construction of exceptions applies to such nonrecognition sections. The regulation then goes on to spell out exceptions in terms of differences in the property exchanged:

> (c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 721, 1031, 1035 and 1036. *These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial.* As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

Treas. Reg. § 1.1002-1 (emphasis added).

The realization requirement of material difference does not undercut these Code sections. It only provides a minimal standard that items exchanged may not be identical, fungible commodities. Such nonrecognition provisions as the wash sales rule (§ 1091) and the like kind exchange rule (§ 1031) are bright line rules dealing with specific circumstances not necessarily addressed by the material difference requirement of realization. Furthermore, these non-

recognition sections are not coextensive with the material difference requirement. Section 1031, the like kind exchange rule, specifically omits coverage of evidence of indebtedness, such as mortgages, and hence is inapplicable to the present case. Section 1091 also fails to apply other evidences of indebtedness, only covering securities and stocks.

SASA contends that the material difference requirement leads to untenable and administratively impossible economic analyses of the position of all parties and all things exchanged, and argues that this is illogical because realization is a concept based largely on administrative convenience. *Helvering v. Horst*, 311 U.S. 112, 116, 61 S.Ct. 144, 147, 85 L.Ed. 75 (1940). We do not read the material difference requirement of realization as demanding extensive analysis of the economic situations of persons involved in the exchange after such an exchange has occurred. The "material difference" inquiry does not examine whether items are "economic substitutes" or not. Such a determination is the realm of the like kind rule, which as noted above is inapplicable here.

We reject the administrative "parade of horribles" proposed by SASA on this point because the material difference requirement of realization is something that has always been required, and is essentially merely an extension of the "form over substance" principle into the area of realization. Thus, we see the prior interpretation of Treas. Reg. § 1.1001-1(a)'s "differing materially" language as a non-detailed reference to the requirements of realization previously well developed in the caselaw. Since the Code provides no independent definition of realization, but refers to it in § 1001, it is appropriate to employ judicial interpretations of the concept of realization.

We conclude that there is a material difference requirement which has been developed by the cases and confirmed by the Treasury Regulations.

II. *The Properties Exchanged in the R-49 Transaction are Materially Different*

Of the five lower court cases (other than the one at issue) which have addressed the question of R-49 transactions, the three tax court cases all held that the groups of mortgages exchanged were materially different from each other. *Cottage Savings*, 90 T.C. at 395; *FNMA*, 90 T.C. at 422-23; *Leader Federal Sav. & Loan*, 57 T.C.M. at 849-50. The two district court cases both held that the mortgage packages were not materially different from each other. *Temple*, 694 F. Supp. at 244-45; *Centennial*, 682 F. Supp. at 1398-99. We find the rationale behind *FNMA* and *Cottage Savings* is correct, and we affirm the tax court's finding in the instant case that the mortgages exchanged in the R-49 transaction were materially different.

A. The Cottage Savings and FNMA analysis

The tax court below relied heavily on the rationale employed in *Cottage Savings*. SASA, 55 T.C.M. at 815-17. *Cottage Savings* held that the participation interests in the mortgages exchanged were materially different because the collateral and obligors were different.

> Although the loans were similar, there were important differences. Specifically, the loans had different obligors and were secured by different pieces of reality. The subsequent history of payments on the loans . . . shows that the transactions were real, not feigned, and that the assets

> received were not the same as the assets given up. In the instant case (unlike *Shoenberg* and *Horne*), when the smoke cleared away petitioner was left with assets that were different (and performed differently) from what petitioner had at the start. Thus, application of the principle of *Horne* and *Shoenberg* to the December 31, 1980, transactions leads us to conclude that the property is materially different, and petitioner is entitled to the claimed deductions.

Cottage Savings, 90 T.C. at 394.

The *Cottage Savings* court was further guided by *Hanlin v. Commissioner*, 38 B.T.A. 811, *aff'd* 108 F.2d 429 (3rd Cir. 1939). *Hanlin* was held to support the taxpayers' position but not to be controlling, because it involved the wash sales provision, § 118 of the Revenue Act of 1932,[5] rather than the realization requirement of material difference. The tax court held in *Hanlin* that bonds of the St. Louis and Wichita Federal Land Banks were not substantially identical to bonds of the Louisville Federal Land Bank, because the bonds were issued by different obligors and the assets underlying the bonds of those obligors were also different. *Hanlin*, 38 B.T.A. at 819-20.

When affirming the tax court's decision in *Hanlin*, the Third Circuit downplayed the difference between the bonds' obligors, stating that "[t]hese institutions are all under the supervision of one central authority, formerly the Federal Farm Board, now the Farm Credit Administration. . . . They are at least secondarily liable on each other's bonds. . . ." *Hanlin*,

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[5] Section 1091 of the current Code is the successor to § 118 of the Revenue Act of 1932, and has been conceded by the IRS not to be applicable to this case.

108 F.2d at 430-31. The Third Circuit, however, did uphold the ruling that the bonds were materially different because the collateral security underlying the bond issues was significantly different.

> It cannot be denied, however, that the collateral security underlying the bond issues of different Land Banks, is physically distinct. That collateral, consisting of United States bonds and first mortgages, is held in trust by the farm loan registrar for the issuing bank and the prospective holders of its bonds. . . . The statutes and decisions give no indication that such collateral is pooled indiscriminately behind all the outstanding bonds of all the Land Banks. . . . Consequently, the credit of the United States being what it is, we must, for example, discriminate, if at all, between first mortgages on farms in the vicinity of Louisville, and on those round about Wichita. Those mortgages are, to be sure, selected according to searching and uniform standards, 12 U.S.C.A. §§ 723(a), 751-756. But can it be said that there is no substantial variance in agricultural and financial resource when Louisvillites are contrasted with Wichitavians? Though the average sense of obligation may well be the same, even an economist must recognize, by geographical definition, a salient divergence in, say, the type (and marketability) of crops produced—or, perhaps, the likelihood of dust storms. This difference, we think, deprives the bonds of one Land Bank of substantial identity with those of another.

The IRS argued that the mortgages involved in *Cottage Savings* were distinguishable from those in *Hanlin* because the geographical variation in risks

to farm property was absent in *Cottage Savings*, which dealt only with residential real estate. The *Cottage Savings* court held however that in *Hanlin*

> each bond was secured by a mass of mortgages, so that only a regional disaster could affect the security of the bonds. Thus, in *Hanlin*, the courts focussed on regional differences. In the instant case, each obligation apparently is secured by one residential property, so that a misfortune affecting one family or one property could affect what happens to that obligation without affecting any of the other obligations.

Cottage Savings, 90 T.C. at 395-96. For this reason, the *Cottage Savings* court concluded that the taxpayers' position that the mortgages involved in the R-49 transactions were materially different was even stronger than the meritorious claim in *Hanlin* that the bonds of the federal land banks were substantially different.

The court in *FNMA* arrived at the same conclusion as in *Cottage Savings*, holding that different obligors and also different collateral properties each independently constituted a material difference. *FNMA*, 90 T.C. at 422-23. The *FNMA* court went on to note that the different rates of foreclosure, prepayment, and delinquency experienced after the transactions confirmed the mortgages' material difference. *Id.* The *FNMA* court also held that the overt identity of market value of the two pools of mortgages exchanges was not determinative. While the face amount and maturity of two obligations might be the same, the underlying securities could be radically different. *FNMA*, at 90 T.C. at 423.

In the instant case, SASA acquired 90% participation interests which it gave up in residential mort-

gages in San Antonio. In *Cottage Savings*, most of the properties underlying the mortgages were inside the Cincinnati "beltway," although there apparently were differences in the distribution of the in-beltway properties which were exchanged, and at least some of the properties ranged as far as 120 miles from Cincinnati. The court in *Cottage Savings*, found that although "diversification by geography and other factors may be reasons for reciprocal sales transactions generally, such factors were not considered in the . . . transactions." *Cottage Savings*, 90 T.C. at 382. Because the ruling by the Court below was made on summary judgment, the facts were required to be construed in the best light possible for the nonmoving party, the IRS. The IRS conceded that if the facts were construed most favorably for it they would be essentially the same as those found in *Cottage Savings*. *SASA*, 55 T.C.M. at 814. Hence the geographic distinctness of the two groups of mortgages exchanged between SASA and its trading partners did not play a role in the summary judgment finding that the mortgages were materially different. Nevertheless, because the mortgages had different obligors and were secured by different pieces of reality, the tax court below concluded that they were materially different. *SASA*, 55 T.C.M. at 816.

We uphold the finding of the lower court that different obligors and collateral result in mortgage participation interests which are materially different.

B. The economic substitute analysis

In contesting the conclusion that the mortgages exchanged by SASA were materially different, the government urges that the R-49 transaction is specifically designed to leave the S & Ls in the same

economic position as they were when they began. The participating S & Ls are supposed to receive new mortgages with the same risk of default and delinquency as the old mortgages. Hence, there can be no material difference between the things exchanged. This position may be summed up as follows: "In an R-49 transaction risk does not transfer." Risk consists of the best predication of potential future performance of the mortgage at the time of transfer, and when the mortgages meet the ten requirements of an R-49 transfer the risk associated with each mortgage is identical at the time of that transfer. The IRS therefore argues that because the risks associated with the mortgages involved in the R-49 transfer are indistinguishable, the mortgages involved are "economic substitutes" for each other. *See Temple*, 694 F.Supp. at 245.

Another way of phrasing this argument is that once the mortgages have been matched according to the ten criteria of R-49, the marketplace cannot distinguish between the loan packages. It cannot be predicted at the time of the exchange which set of mortgages will perform better, the secondary mortgage marketplace therefore assigns them equal value, and they are as fungible a commodity as coffee or wheat. *Centennial*, 682 F.Supp. at 1399.

The weakness in the government's argument is that the requirement of "material difference" does not go so far. Treas. Reg. § 1.1001-1(a) when referring to (although not establishing) the material difference requirement alludes to the exchanged property as differing "materially in either kind or extent." It does not say "differing materially for economic purposes." The case law which establishes the requirement of material difference as a part of reali-

zation simply does not equate "materially different" with "not an economic substitute." The corporate reorganization cases did not rely on an analysis of whether the assets of the new corporation would perform in the same way as the old one.

The determination of whether two items are economic substitutes belongs to a broader inquiry; that of like kind exchanges. Essentially, the IRS is reading a universal like kind exchange rule into the requirement of material difference when it urged that "economic substitutes" cannot be materially different. Instead, the proper standard is that stated in *Weiss*; an asset given up must be really and truly different from the asset received in order for an exchange to be a realization event. *See Weiss v. Stearn*, 265 U.S. at 254, 44 S.Ct. at 492 (no gain is recognized unless the taxpayer received "a thing really different from that which he therefore had").

Allowing the marketplace to determine whether or not two mortgages are materially different is flawed. Just because two mortgages are assigned the same value in the secondary mortgage marketplace does not mean they may not be different in a host of other ways. *See FNMA*, 90 T.C. at 423.

The IRS contends however that not only were the R-49 mortgage packages of similar value, but when matched with the ten R-49 criteria, the known risk or predicted economic performance associated with the mortgages was the same. If the government's "predicted economic performance" interpretation of the material difference requirement were employed, however, the results would be dire. Exchanges of items which were clearly different would not necessarily constitute realization events. For example, if two taxpayers exchanged two bonds of different cor-

porate entities engaged in entirely different businesses, but which have the same rating by Moody's, the same interest rate, the same cash flow, the same maturity and the same value in the capital market then no change in their "economic status" would have occurred. The transaction, would, nevertheless be real, and the taxpayer should not be able to postpone losses and gains while switching bonds or other assets merely because they are "economic substitutes."

Administration of § 1001 would be considerably complicated if the courts had to define the relevant marketplace and then determine exactly how that market perceived a reciprocal exchange of mortgage loans or any other exchange involving similar assets. The courts would have to determine which sources of information establish the market price, differentiate specific investment factors peculiar to individual assets, and specify what discrete information was or was not available to be perceived and acted upon by participants in that marketplace.

As a corollary to the "economic substitute" argument, both the *Temple* and *Centennial* cases stated that the S & Ls involved in their respective cases did not examine the mortgages and their prospects any further than by ensuring that they met the ten criteria of R-49. *Temple*, 694 F.Supp. at 245; *Centennial*, 682 F.Supp. at 1399. Indeed, the matching which put together the relevant mortgage packages in both *Temple* and *Centennial* was done by computer. This argument assumes that the subjective perceptions (or lack thereof) of the S & Ls involved must be taken into account in order to determine whether a transaction involved materially different items or not. Essentially, the *Temple* and *Centennial* courts were stating that because the R-49 transaction

at issue was not a horse trade, with each party seeking to gain an advantage through the swap transaction, there was no material difference in the items being swapped. It must be the objective and not subjective factors, however, which determine whether a realization event occurred. Otherwise the Code could not be fairly applied to disparate individuals.

We reject the IRS's interpretation of "materially different," which would rely upon an "economic substitute" requirement and hold that while "material difference" requires more than purely formal differences, an "economic substitute" can still sometimes be materially different.

C. Centinnial's "no richer—no poorer" analysis

Realization does not require that a taxpayer must be "richer or poorer" as a *result of the exchange itself*. Generally items exchanged will be of equivalent value. If the property exchanged in a straight swap was not roughly equal in value, either one party did not get the market rate or the exchange was a sham transaction. In order for realization to occur, a gain or loss must occur which leaves the taxpayer *ultimately* richer or poorer, the realization event fixes that loss or gain. The realization event itself, however, need not cause the loss or gain. In this case, the mortgages declined in value not because of the exchange, but rather as a result of market depreciation.

The *Centennial* court urged:

> R-49 . . . prevented the realization of a tax loss. *Centennial was no poorer after the transaction than before.* It reflected no loss on its books for regulatory and accounting purposes. . . . It appears to the Court that by means of a mortgage swap, *Centennial hoped to create a loss without any real change in its economic status.*

> Taxation, however, is concerned with realities rather than appearances, *Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir.1971), and no loss can be claimed that is not real. The loss which Centennial claims it suffered as a result of the transaction is the paper loss it had been suffering all along because its old fixed-rate mortgages had declined in value. A decline in valuation without realization, however, is not enough to entitle an institution to deduct a loss.

Centennial, 682 F.Supp. at 1400 (emphasis added).

To the extent *Centennial* relies on its no richer/no poorer analysis, it is incorrect on the facts of these R-49 cases. The basis for *Centennial's* finding of no realized loss actually is no more than an assertion that no change in economic status occurred, and the *Centennial* opinion suffers the flaws of economic substitute analysis set out above.

D. Post transaction performance

The tax court in *Cottage Savings* and *FNMA* noted that its holding that the mortgages were materially different was confirmed by the fact that the performance of the mortgages after the exchange differed from each other. *Cottage Savings*, 90 T.C. at 394; *FNMA*, 90 T.C. at 422-23. *Temple* states that the post hoc performance of the mortgages cannot matter because the risk involved with each package of mortgages was the same at the time of the swap. *Temple*, 694 F.Supp. at 245. This conclusion misses a critical point. It is an assumption inherent in the *Hanlin* holding that different obligors and different collateral *must result* in different performance. Real property and individual human beings are in these cases the collateral and obligors. It is elementary in the law that real property, even residential property

of the same general value, is unique. So is each person. Because the value of the mortgages depends on the performance of these unique entities (people in paying their obligations and real estate in retaining its value in the market) an exchange of residential mortgages is not like swapping identical fungible commodities. Post hoc performance is not necessary to prove the mortgages' uniqueness, but it is a result confirming it.

E. The weight given to the FHLBB determination of substantial identity

Admittedly at first glance the statement that two items can at the same time be "substantially identical" and "materially different" seems illogical. The critical consideration is, however, that the "substantially identical" language is employed by the FHLBB as an administrative accounting matter to carry out its own regulatory obligations. The "materially different" requirement is employed by a different agency, the IRS, in carrying out its separate regulatory responsibilities. Each of these phrases is a regulatory statement created for and used for a different administrative purpose.

The IRS urges that under *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 100 S.Ct. 790, 63 L.Ed. 2d 22 (1980) the determinations of regulatory agencies are to be granted respect. So they are—but as to both the IRS and the FHLBB. The FHLBB is not in the business of interpreting the Internal Revenue Code. So also the IRS is not supposed to interpret the Federal Home Loan Bank Act. Here the IRS is arguing that deference should be shown in a tax determination case to a ruling by an agency which is not charged with enforcing the tax code. The

FHLBB held that mortgages in R-49 exchanges are "substantially identical" for its own accounting. The IRS would have us defer to the FHLBB on the "substantial identity" but not on the "material difference" of the loans, and it would apply the "substantial identity" ruling (an accounting ruling) to the tax standard of "material difference." "[I]t has been consistently held that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws, which establish their own standards." *Bellefontaine Federal Sav. & Loan Ass'n. v. Commissioner*, 33 T.C. 808, 811-812 (1960). Hence, the FHLBB's determination that mortgages exchanged in an R-49 transaction are "substantially identical" for its accounting purposes is of no direct relevance when examining whether mortgages under R-49 are "materially different" for purposes of the Internal Revenue Code.

In conclusion, we hold therefore, as did the tax court, in this case and in *Cottage Savings* and *FNMA* that the mortgages exchanged are indeed materially different under the IRC.

III. *Section 165*

Finally, the government argues that SASA cannot claim the losses on the mortgages it exchanged because of § 165 of the IRC and associated regulations. That section states

> (a) *General Rule*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

26 U.S.C. § 165 (1982). The Treasury Regulation associated with this section states

> (b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

Treas. Reg. § 1.165-1(b).

The tax court rejected this argument by the government. *SASA*, 55 T.C.M. at 815. The IRS conceded for summary judgment purposes that the facts in this case could be no more favorable to its position than those found in *Cottage Savings*. Given that acknowledgment, the court held:

> We will therefore assume for purposes of petitioner's motion [SASA's summary judgment motion] that the transaction entered into by SASA was motivated solely by tax considerations, that the transaction was closed and completed and changed the flow of economic benefits from the loan participations, and that the measurement of the loss is not separately disputed. The transaction will not be found to lack economic substance in these circumstances.

SASA, 55 T.C.M. at 815.

The tax court in both *Cottage Savings* and *FNMA* when ruling on similar arguments based on § 165 concluded that when the taxpayers participated in closed and completed transactions with the actual transfer of economic benefits from the loan participations, § 165 was not applicable. *Cottage Savings*, 90 T.C. at 401-02; *FNMA*, 90 T.C. at 425-26.

We uphold the tax court's finding. The government's argument with reference to § 165 is a different facet of its previous argument that the loss sustained by SASA was not economically real. Even if it is conceded (as it was for summary judgment purposes) that there was no purpose for the R-49 transaction other than tax reduction, nevertheless SASA suffered a real economic reduction in the value of the mortgage participation interests it transferred and the economic reality of that loss was fixed by an identifiable event, an exchange of materially different items.

The government in pursuing its argument that losses resulting from transfers lacking in economic substance are not deductible cites four cases as supporting this proposition. Three of those cases involve situations in which there was no genuine, arm's length, completed transaction which disposed of the property. *Higgins v. Smith*, 308 U.S. 473, 60 S.Ct. 355, 84 L.Ed. 406 (1940) (involving sale by a taxpayer of securities to a corporation wholly owned by the taxpayer); *Fender v. United States*, 577 F.2d 934 (5th Cir.1978) (involving sale of unrated municipal bonds to a bank over which taxpayers had sufficient influence so that the bonds could be later repurchased); *Scully v. United States*, 840 F.2d 478 (7th Cir.1988) (involving sale of real estate by trustees of family trust to other family trusts which had the same fiduciaries, beneficiaries, and remainderman). In contrast to these cases, in the R-49 transaction at issue a genuine completed transaction occurred between two legally independent entities which conclusively severed their rights to the items exchanged.

The government also cites *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir.1988). In that case the Sev-

enth Circuit held that individual investors were not entitled to deductions for losses incurred in trading options, straddles, and hedges on the London metal exchange, because the investors' losses lacked economic substance and did not change the individual's investment positions. The investors in *Yosha* placed a deposit with a broker with the understanding that they were not purchasing options with genuine market risks but rather tax deductions. The brokers guaranteed the investors that the only consequences of their trading would be tax consequences, and the brokers organized that trading to provide the taxpayers with an ordinary income loss and no capital gains in the first year, and long term capital gains in the second year. The investing taxpayers never faced the possibility either of actual gains or losses on the trading as the gains were retained and the losses absorbed by the brokers. *Yosha*, 861 F.2d at 500.

Yosha involved an entirely different circumstance from the one presented in the case at hand. Here the S & Ls involved in the R-49 transaction genuinely experienced a decline in the market value of their mortgages. They sought to realize that loss by the disposition of their mortgages in closed transactions. The loss was not created for tax purposes; its existence was entirely independent of the R-49 transaction. We conclude that 165 of the Code and Treas. Reg. 1.165-1(b) do not apply to the facts of this case.

Conclusion

The mortgages which SASA exchanged in the R-49 transaction with Dallas Federal and Farm and Home were materially different. Further, the losses experienced were genuine and the result of market forces independent of the R-49 transaction. We up-

hold the finding of the tax court allowing SASA the deduction of $14,956,898 under the Internal Revenue Code as loss realized through the exchange of materially different property.

AFFIRMED.

APPENDIX B

T. C. Memo. 1988-204

UNITED STATES TAX COURT

Docket No. 47016-86

SAN ANTONIO SAVINGS ASSOCIATION AND SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESONDENT

Filed May 5, 1988

MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, *Judge*: Petitioner has moved for summary judgment determining that it realized and may recognize a loss from the concurrent sale of 90 percent participation interests in some of its residential first mortgage loans and purchase of 90 percent participation interests in different mortgage loans (the transaction). Three theories for disallowing the loss claimed have been advanced by respondent, as follows: First, the taxpayer merely swapped or exchanged mortgage loan participation interest packages that were materially or substantially the same, thereby precluding a realization even under section

1001.[1] Second, the statutory wash sale provisions of section 1091 preclude recognition of losses from the mortgage swap transactions because the exchanged properties constituted substantially identical securities. Third, even if the mortgage swap triggered a realization event under section 1001, and section 1091 does not apply, section 165 would preclude recognition of the losses claimed because the transaction lacked economic substance, serving no purpose other than to secure tax losses. Each of these arguments, according to respondent, inherently involves disputed questions of fact.

During the pendency of Petitioner's Motion for Summary Judgment, the Court filed its opinions in the cases of *Cottage Savings Assoc. v. Commissioner* (*Cottage Savings*), 90 T.C. —— (Mar. 14, 1988), and *Federal National Mortgage Assoc. v. Commissioner* (*FNMA*), 90 T.C. —— (Mar. 14, 1988). Subsequent to the opinions in *Cottage Savings* and *FNMA*, respondent has acknowledged that the mortgage exchange transactions in those cases and the transaction in this case were virtually identical. Respondent has also advised the Court that he is no longer arguing in this case that section 1091 applies, but that he continues to maintain the other positions set forth above. In the interest of expeditious resolution of this case, however, respondent has acknowledged that if this case were tried, or construing the facts most favorably for respondent for purposes of Petitioner's Motion for Summary Judgment, then the facts in this case would be essentially the same as

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended and in effect during the years in issue.

those found by the Court in the *Cottage Savings* opinion.

As in *Cottage Savings* and *FNMA*, the transaction in issue here was intended to comply with Memorandum R-49, a statement issued by the Federal Home Loan Bank Board, the agency that regulates the thrift industry. Memorandum R-49 provided that concurrently "sold" and "purchased" loans need not be reported as losses for financial statement purposes if 10 criteria of similarity between the transferred and acquired loans were satisfied.

On September 30, 1980, petitioner San Antonio Savings Association (SASA) transferred to Farm and Home Savings Association, Nevada, Missouri (Farm and Home), 90 percent participation interests in each of approximately 1,808 conventional first mortgage loans owned by SASA. The remaining principal balances on those loans aggregated $83,082,772, of which 90 percent was $74,774,495. On the same date SASA received from Farm and Home a wire transfer of cash in the amount of $59,817,597. All of the participation interests in the mortgage loans transferred were secured by residential properties located within the metropolitan area of San Antonio, Texas.

Also on September 30, 1980, SASA acquired from Dallas Federal Savings and Loan Association of Dallas, Texas (Dallas Federal), 90 percent participation interests in each of approximately 1,834 conventional first mortgage loans owned by Dallas Federal. On the same date, SASA transmitted, by means of a wire transfer, cash in the amount of $60,925,730 to Dallas Federal. Ninety percent of the remaining principal balances on the underlying mortgage loans was $74,802,167. All of the acquired participation interests were secured by residential properties lo-

cated within the metropolitan area of Dallas, Texas. On November 15, 1980, the number of participation interests acquired by SASA from Dallas Federal was reduced, resulting in a refund of $1,046,905 paid by Dallas Federal to SASA; SASA's net payment for the participation interests it acquired was $59,878,825.

Also on September 30, 1980, Farm and Home transferred to Dallas Federal 90 percent participation interests in conventional mortgages. The remaining principal balances on these mortgages and the cash payment from Dallas Federal to Farm and Home were approximately the same amounts as the principal balances and cash amounts involved in the transfers between SASA and Farm and Home, and SASA and Dallas Federal described above.[2]

For its taxable year ended September 30, 1980, SASA deducted $14,956,898 as a loss from the Farm and Home transfer. The deduction claimed was equal to the difference between 90 percent of the remaining principal balances of the mortgage participation interests sold and the amount of cash received from Farm and Home.

SASA transferred, without recourse, complete legal and beneficial ownership of the participation interests in the mortgage loans sold to Farm and Home. SASA has not reacquired any ownership interest in those mortgage loan participations. SASA acquired complete legal and beneficial ownership of the participation interests in the mortgage loans acquired from

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[2] The facts concerning the transfer between Farm and Home and Dallas Federal are set forth in an affidavit in support of respondent's opposition to petitioner's motion and are not disputed by petitioner. That aspect of the transaction is before he Court in *Dallas Federal Savings and Loan Assoc., et al. v. Commissioner,* docket No. 42819-86.

Dallas Federal, and SASA has not retransferred any ownership interests in those mortgage loans to any other person.

Respondent contends that the sole purpose of the transaction among SASA, Farm and Home, and Dallas Federal was tax avoidance. Petitioner alleges that the transaction resulted in diversification of petitioner's loan portfolio, because the mortgage loans transferred by SASA to Farm and Home were secured by properties located in the San Antonio, Texas, area, while the mortgage loans acquired by SASA from Dallas Federal were secured by properties located in the Dallas, Texas, area. Petitioner argues, however, that its motive for entering into the transaction is irrelevant. From the opinions of the Court in *FNMA* and *Cottage Savings*, it is apparent that the taxpayer's motive in entering into the mortgage exchange transactions is relevant but not conclusive.

In *FNMA*, the taxpayer was a for profit, privately owned, corporation with close ties to the Federal Government, and the largest investor in home mortgages in the United States. FNMA provides liquidity for mortgage investments primarily by purchasing mortgages from lenders, using funds it acquires by issuing stock and debt securities. We found that FNMA conducted the transactions in issue for a number of reasons in addition to recognizing losses for tax purposes, summarizing those reasons as follows:

> Those reasons included: increasing its holdings of urban loans; expanding its customer base by developing relationships with savings and loan associations; increasing the portion of its portfolio with enforceable due-on-sale clauses; and bolstering the secondary mortgage market by helping ailing savings and loan associations to

> diversify their portfolios and to recognize losses for tax purposes. [90 T.C. at —— (slip opinion at p. 14).]

We rejected respondent's argument that the transactions "lacked economic substance and reality" and were not deductible. 90 T.C. at —— (slip opinion at p. 33).

In *Cottage Savings*, we stated of the transactions there in issue:

> The transfers were solely tax-motivated. That is, although participations often are sold for a variety of business reasons, in the instant case the loan participation sales and offsetting purchases were effectuated solely to reduce petitioner's tax liabilities (and, presumably, the tax liabilities of petitioner's trading partners). This, by itself, is not fatal to petitioner's claimed deduction in the context of the instant case (see, e.g., secs. 183(a) and 165(c)(2) for situations where this purpose might be conclusive), but it does require us to scrutinize the record with particular care. *Joseph E. Widener, Trust No. 5 v. Commissioner*, 80 T.C. 304, 310 (1983). [Fn. refs. omitted; 90 T.C. at —— (slip opinion at pp. 25-27).]

In both *Cottage Savings* and *FNMA*, we concluded that the exchanges in which the taxpayer participated resulted in closed and completed transactions within the meaning of section 165 and section 1.165-1(b), Income Tax Regs. *FNMA*, 90 T.C. at —— (slip opinion at p. 33); *Cottage Savings*, 90 T.C. at —— (slip opinion at pp. 45-46). Thus, although we examined the motives of the taxpayers, the decisive findings related to an actual transfer of the economic

benefits from the loan participations. See *Cottage Savings*, 90 T.C. at —— (slip opinion at p. 19, 28); *FNMA*, 90 T.C. at —— (slip opinion at pp. 12, 33).

Normally a taxpayer's motive for entering into a transaction and the closed and completed nature of the transaction are questions of fact to be determined after trial. The correct amount of any claimed loss may also be disputed. See *Cottage Savings*, 90 T.C. at —— (slip opinion at p. 27 n. 11). In this case, however, we may rely on respondent's acknowledgment to the effect that the facts in this case are no more favorable to respondent's position than the facts found in *Cottage Savings*. We will therefore assume for purposes of petitioner's motion that the transaction entered into by SASA was motivated solely by tax considerations, that the transaction was closed and completed and changed the flow of economic benefits from the loan participations, and that the measurement of the loss is not separately disputed. The transaction will not be found to lack economic substance in these circumstances.

As indicated above, respondent's primary challenge to petitioner's deduction of losses incurred in the loan exchange transaction is that petitioner did not realize a loss under section 1001 because the sale of simultaneous purchase of loan participation interests did not constitute "the exchange of property for other property differing materially either in kind or in extent." The quoted language appears in section 1.1001-1(a), Income Tax Regs.[3] Petitioner contends

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[3] We have decided petitioner's motion in accordance with the majority opinions in *Cottage Savings Assoc. v. Commissioner*, 90 T.C. —— (Mar. 14, 1988), and in *Federal National Mortgage Assoc. v. Commissioner*, 90 T.C. —— (Mar. 14, 1988). The author still holds the view expressed in a concurring

that, as a matter of law, the mortgage loan participation interests differed materially in kind or in extent because both the obligors and the underlying security of each loan were different. Petitioner relies on *Hanlin v. Commissioner*, 38 B.T.A. 811 (1938), affd. 108 F.2d 429 (3d Cir. 1939).

In *Cottage Savings*, we described *Hanlin* and its applicability to the mortgage swap transactions as follows:

> In *Hanlin* we applied the wash sales provision, section 118 of the Revenue Act of 1932,[18] to three sets of transactions. We held that municipal bonds of the same obligor (Philadelphia) with insignificant differences in maturity dates were substantially identical securities. 38 B.T.A. at 813-818. We held that Federal Land Bank bonds of the same obligor (Omaha Federal Land Bank) with insignificant differences in maturity dates were substantially identical securities. 38 B.T.A. at 818-819.
>
> However, we also held that bonds of the St. Louis and Wichita Federal Land Banks were not substantially identical to bonds of the Louisville Federal Land Bank. 38 B.T.A. at 819-820. We rested our decision on the difference in obligors and the difference in assets underlying the promises of the different obligors. The Circuit Court of Appeals for the Third Circuit affirmed our conclusions as to all three sets of securities except that, with regard to the St. Louis, Wichita,

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opinion in *Cottage Savings*, 90 T.C. at —— (slip opinion at pp. 49-51), that there is no requirement applicable in this case that the properties exchanged differ materially in kind or in extent. Either view would lead to a decision for petitioner in this case.

and Louisville Federal Land Banks, the Circuit Court of Appeals focussed more on the differing underlying securities than on the differing obligors. 108 F.2d at 431.

In the instant case, the obligors are different and the underlying securities are different. The *Hanlin* standards lead us to conclude that the mortgage participations that petitioner acquired differ materially from the mortgage participations that petitioner transferred.

Respondent insists that the *Hanlin* criteria support his position in the instant case. He points out that the Circuit Court of Appeals in *Hanlin* focussed on the geographic difference between farmland near Wichita and farmland near Louisville, and directs our attention to the fact that "The geographical variations in risks of farm property which were critical to the decision in *Hanlin* are not present in this case, which involves residential real estate." Respondent overlooks the fact that *Hanlin* involved Federal Land Banks, each of which was at least secondarily liable on the debts of the others (108 F.2d at 431), while the instant case involves individual borrowers who apparently are each liable on only their own obligations. Respondent also overlooks the fact that, in *Hanlin*, each bond was secured by a mass of mortgages, so that only a regional disaster could affect the security of the bonds. Thus, in *Hanlin*, the courts focussed on regional differences. In the instant case, each obligation apparently is secured by one residential property, so that a misfortune affecting one family or one property could affect what happens to that obligation without affecting any of the other obliga-

tions. We conclude that petitioner's position in the instant case is stronger than the position that the taxpayer in *Hanlin* took with respect to the bonds of the St. Louis, Wichita, and Louisville Federal Land Banks.

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[18] In the instant case, respondent expressly concedes the inapplicability of sec. 1091, the successor to sec. 118 of the Revenue Act of 1932. [90 T.C. at —— (slip opinion at pp. 36-38).]

In neither *Cottage Savings* nor *FNMA* did the Court hold that *Hanlin* controlled, but in each case we indicated that *Hanlin* supported petitioner's position. See *FNMA*, 90 T.C. at — (slip opinion at p. 31-32). In each case, we concluded that the properties exchanged were materially different, emphasizing that the loans had different obligors and were secured by different pieces of realty.[4] In *Cottage Savings*, we

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[4] [Cottage Savings] * * * exchanged participations in some loans for participations in other loans. Although the loans were similar, there were important differences. Specifically, the loans had different obligors and were secured by different pieces of realty. The subsequent history of payments on the loans * * * shows that the transactions were real, not feigned, and that the assets received were not the same as the assets given up. * * * [*Cottage Savings*, 90 T.C. at —— (slip opinion at pp. 35-36).]

* * * * *

The mortgages that [FNMA] received did not represent the same property rights as the mortgages that [FNMA] exchanged. As we found *supra*, the mortgages that [FNMA] received were obligations of different parties than the mortgages that [FNMA] exchanged. Additionally, the mortgages that [FNMA] received were collateralized by different properties than the mortgages than [FNMA] exchanged. We consider both of these differences to be material differences. The fact that the mort-

also noted the difference between ownership of mortgage loans and a 90 percent participation interest in such loans. 90 T.C. at — (slip opinion at pp. 28, 47).

In both *Cottage Savings* and *FNMA* we rejected respondent's arguments that the properties exchanged should be regarded as the packages of loan participation interests and treated as "mass assets" for purposes of comparison. *Cottage Savings*, 90 T.C. at — (slip opinion at pp. 38-41); *FNMA*, 90 T.C. at — (slip opinion at pp. 29-30). A contrary result was reached by the District Court in the case of *Centennial Savings Bank FSB v. United States*, —— F. Supp. —— (N.D. Tax., Jan. 22, 1988), upon determining that the parties looked to the totality of the loan packages rather than the individual loans in entering into their transactions. Although we have expressly disagreed with the analysis in *Centennial Savings Bank FSB, Cottage Savings*, 90 T.C. at — (slip opinion at pp. 46-48), that disagreement itself suggests a potential for factual dispute that in the ordinary case would preclude summary judgment. In view of respondent's acknowledgment that this case cannot be distinguished to respondent's advantage from *Cottage Savings*, however, *Cottage Savings* and *FNMA* compel the conclusion that the mortgage loan participation interests acquired by petitioner from Dallas Federal were materially different from the loan participation interests sold by petitioner to Farm and Home.

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gages that [FNMA] received have experienced different rates of foreclosure, prepayment, and delinquency since the [Concurrent Mortgage Sales] transactions took place confirms that the mortgages [FNMA] received were "really different from what he theretofore had." [*FNMA*, 90 T.C. at —— (slip opinion at pp. 27-28).]

For the foregoing reasons, the Court concludes that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. Petitioner's Motion for Summary Judgment will be granted.

Decision will be entered under Rule 155. (changed by 5/6 order)

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 88-4717

SAN ANTONIO SAVINGS ASSOCIATION
AND SUBSIDIARIES, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLANT

APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

ON PETITION FOR REHEARING AND
SUGGESTION FOR REHEARING EN BANC

(Opinion 11/02/89, 5 Cir., 198—, —— F.2d ——)

(January 18, 1990)

Before: BROWN, WILLIAMS and JOLLY, Circuit Judges.

PER CURIAM:

(X) The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active

service on the Court having requested that the Court be polled on rehearing en banc, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ J. S. Williams
United States Circuit Judge

APPENDIX D

The Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the tax year at issue, provided in pertinent part:

§ 165. Losses

(a) General rule

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

§ 1001. Determination of Amount of and Recognition of Gain or Loss.

(a) Computation of Gain or Loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of Gain or Loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

* * * * *

The Treasury Regulations on Income Tax (26 C.F.R.) provide in pertinent part:

§ 1.1001-1 Computation of gain or loss

(a) General rule

Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations there-

under (*i.e.*, the cost or other allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).

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